



Creative Global Investments

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IMF Says China's Currency No Longer Undervalued

The IMF has reversed its long-term view and no longer believes that the Renminbi is undervalued. According to Monday's published statement by the just completed IMF Mission to China: "While undervaluation of the Renminbi was a major factor causing the large imbalances in the past, our assessment now is that the substantial real effective appreciation over the past year has brought the exchange rate to a level that is no longer undervalued...we believe that China should aim to achieve an effectively floating exchange rate within 2-3 years....As part of the ongoing review of the Special Drawing Rights (SDR) basket at the IMF, the Chinese authorities have stated publicly their interest in including the Renminbi in the SDR basket. We welcome and share this objective and will work closely with the Chinese authorities in this regard. As the Managing Director of the IMF has said, RMB inclusion is not a matter of "if" but "when". The Renminbi rose against all 31 major currencies during the past twelve months. **The stage is set for inclusion of the Renminbi in the SDR basket of reserve currencies when the IMF does its review in October.**

Not surprisingly, the U.S. Treasury reiterated its position that the Renminbi remains significantly undervalued. However, this has increasingly become an isolated view as the consensus clearly believes otherwise. It seems a rather difficult view to defend when China has used its foreign exchange reserves to intervene in currency markets to support the Renminbi since the beginning of the year. While the U.S. cites China's capital controls as a key reason to disallow granting reserve currency status to the Renminbi, resistance from the IMF has softened over the past few years as the selective application of capital controls has proven useful to many emerging markets in the wake of the financial crisis and the unwanted excess inflows from the Federal Reserve's own quantitative easing.

If the Renminbi is included in the SDR basket, the Renminbi won't suddenly replace the dollar in world trade or as the world's reserve currency—that will take another decade or two, if it happens at all. The salient point to grasp is that the major impediment to holding Renminbi-based assets is removed as currency convertibility is enhanced.

Lack of China exposure has caused many global equity managers to underperform this year. If the renminbi is included in exchange reserves for SDRs in October, asset managers indexed to global indices would be forced to increase China exposure in order to match allocations to revised index weightings regardless of valuation. Those purchases are likely to be made at higher valuations and push shares prices even higher as foreign buyers return to the market. Local market participants will doubtless drive share prices higher in anticipation of this event.

We noted in a previous report that the steeper the ascent, the deeper the correction. The Shanghai composite index has hit CGI's target of 4,900 and is vulnerable to around 4,400 or even 4,100 should selling volume sustain itself after yesterday's decline on record volume. Those with a short-term trading orientation may consider trimming positions or taking profits. However, we believe that the 'A' shares can still push higher after a period of consolidation. We reiterate that we believe the greater risk for long-term investors is one of not participating and missing out on China's continued bull run.

Government efforts to slow the market's advance in order to prevent it from overheating into a meltdown, such as tighter restrictions on margin lending, are likely to be no more than a temporary restraint against the market's irrepressible rise near term. Yesterday's move by several brokerage houses to tighten margin requirements are likely done either directly or indirectly at the government's behest in another attempt to let some air out of the balloon. Beijing has a vested interest in seeing the stock market continue to rise. What it doesn't want to see is overheating that could spill over into a more material decline, which could weigh on the populace's confidence. China's capital controls limit the investment options for the average Chinese investor. **Stimulus enacted by The People's Bank of China will continue pushing investors into riskier assets just as it has for central banks elsewhere.**



Our preferred vehicle has been the Deutsche X-trackers Harvest CSI 300 China A-Shares ETF (ASHR), which consists of the 300 largest and most liquid China A shares.



Those investors more risk averse but still desirous to play the liquidity-driven China rally should look at Hong Kong. The recently expanded Shanghai-Hong Kong Stock Connect program allows mainland China investors to exploit an approximate 30% arbitrage opportunity by buying less expensive Hong Kong dual-listed shares while settling via the exchange and clearing house in their home market. Conversely, it provides Hong Kong and other foreign investors similar access to China 'A' shares.



We continue to reiterate our long-term contrarian call to buy China; adding to 'A' Share exposure on pullbacks. Despite more than doubling over the past year, the Shanghai Exchange Composite Index still remains approximately 25% below its record closing high of 6,124 on October 16, 2007 and continues to outperform the S&P 500.

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